

- o Ensure consumers have access to all the information needed in order for them to make timely and informed choices about telecommunications products and services and how to best use them;
- o Ensure that universal service programs will allow consumers to select among various technologies offered by competing firms, and ensure that carriers adhere to the same guidelines regarding mutual interconnectivity and interoperability, common carriage, reliability, privacy, and security;
- o Redesign universal service financing so it is "competitively neutral" and has an identified funding source;
- o Provide incentives for efficiency, to significantly reduce the aggregate subsidy required for universal service and to maintain affordable prices for basic service;
- o Provide incentives as needed to promote deployment of advanced telecommunications technology to all customer segments;
- o Provide that education, health care, community and government institutions be positioned to be early recipients of the benefits of the information age; and
- o Preserve and develop opportunities for local flexibility and innovation.

The commenting parties generally agree with these goals, but differ somewhat as to how the Commission can achieve the goals. Differences that parties have with the stated goals are summarized below.

8 R.95-10-020/I.95-01-021, mimeo, pp. 4-5.

GTEC would add structural neutrality as a goal. The Smaller Independent LECs suggest that the goals should be divided into short-run, attainable goals, and long-run goals. The Small LECs suggest that the goals are really objectives, and that a realistic policy is less obvious. Citizens does not agree that universal service should be progressively expanded, nor does it agree that interconnectivity and interoperability belong in the universal service docket.⁹ Citizens also believes there should be a clearer definition of "competitively neutral."

Public Advocates suggests that a goal of universal should be to ensure that all providers of local exchange services be required to achieve a universal service penetration rate of at least 95% for non-white and limited English speaking households. The Coalition, which represents some of the potential providers of local exchange service, agrees with this goal.

As for positioning education, health care, community and government institutions to be early recipients of the benefits of the information age, many of the parties favor such a move. The parties who commented on this issue believe that these types of institutions serve a larger audience, and that such a policy will help to eliminate the stratification between the information rich and the information poor. Some programs are now in place to target these kinds of institutions. However, few parties presented ideas about how this goal can be realized over the long run.

The City of Los Angeles suggests creating incentives to encourage telecommunication providers to subsidize educational access. Citizens believes that the competitive market will

⁹ Interconnection and interoperability standards are best left to the Open Access and Network Architecture Development (OANAD) proceeding, R.94-04-003 and I.93-04-002.

recognize education, health care, and community and government institutions as niche markets, and that market forces will ensure availability of modern technology to these customers. Citizens says that the need for any further market positioning of these institutions is ultimately a social policy question which should be implemented through a legislative initiative, not by the Commission.

C. Discussion

In D.94-09-065, the implementation rate design phase of the new regulatory framework (NRF) for Pacific and GTEC, the Commission recognized that Pacific and GTEC needed to "significantly improve their customer outreach and educational programs to achieve a 95% penetration rate for phone service" among low income, nonwhite, and non-English speaking households.¹⁰ The Commission ordered that Pacific and GTEC file monitoring plans regarding penetration rates.

This 95% goal is a Commission commitment to ensure that all populations in California are afforded universal service, and that technological advancements benefit all segments of the population. Having already addressed this issue in the NRF proceeding, we do not need to address it further, except to state that in a competitive environment, the same requirements should apply to all carriers. We therefore will apply the monitoring requirement to the other providers of local exchange service, such as the competitive local carriers (CLCs), and the other incumbent LECs.¹¹ These providers should include in their annual reports

¹⁰ D.94-09-065, pp. 6-7.

¹¹ Our reference to CLC has the same meaning as that defined in the local competition OIR/OII dated April 26, 1995. We are aware that some parties have suggested in that proceeding that the term CLC be renamed.

their efforts and achievements to improve telephone penetration rates in their service territories, especially among nonwhite, non-English speaking and low income households. As discussed later, their performance may be a consideration in determining whether the provider should be allowed to become a designated carrier of last resort.

We solicit input from parties, and suggest for the Legislature's consideration, whether the standard by which the 95% penetration rate is measured should be modified to use income as the only variable against which penetration is measured. We would like parties' thoughts, and data if available, on whether middle and higher income households, regardless of race, have higher penetration rates than low income households.

We believe that education, health care, community, and government institutions should be in a position to benefit from the information age. Absent suggestions to the contrary, we believe this objective can best be achieved by creating and fostering the development of a competitive market. Potential providers for this market must realize that making certain kinds of telecommunications services widely available to these institutions will increase demand, thereby encouraging the development of a market for these products and services.

Another way to position these kinds of institutions to benefit from the information age is to provide for special rates. However, providing special rates to certain classes of customers, to the exclusion of others for the same type of services, may be contrary to PU Code § 453, and its prohibition against discriminatory rates and charges.

V. Basic Service

A. Introduction

The definition of basic service is important for universal service because it forms the building block for what services customers will receive, and how the subsidies are derived. Although the terms basic service and basic exchange service have been freely used throughout many Commission decisions, no one decision has defined what that means.

In this section, we focus our attention on the definition of basic service, and whether the definition needs to be periodically reviewed to reflect new technology and markets. Before doing so, we need to point out that the fourth stated objective of AB 3643 was to "Develop a process to periodically review and revise the definition of universal service to reflect new technology and markets." (Statutes 1994, Chapter 278, Section 2.(a)(4).) We believe that the reference to a process to review and revise the "definition of universal service" was meant to refer to the definition of basic service. This is apparent by looking at Section 2.(b)(2) of AB 3643, which states in part that "there must be an ongoing evaluation of which services are deemed essential and therefore a part of universal service." The reference to the "ongoing evaluation of which services are deemed essential" suggests that the periodic review contemplated in the fourth objective was for the definition of basic service, and not for the definition of universal service. As AB 3643 notes, those services which are deemed essential are part of universal service. It is those essential services which make up the definition of basic service.

B. Basic Service Definition

1. Introduction

The first step in our analysis of the redesign of universal service is to derive a definition of basic service which

can accommodate technological innovations. Currently, basic service represents a set of telecommunications capabilities which consumers receive when they order service from a monopoly local exchange carrier. Those capabilities have developed over time, and are expressed in various Commission decisions. The basic service definition also serves as the basis for deciding how much low income customers should be subsidized under the ULTS program, and what services should be subsidized in high cost areas. The importance of basic service is that it serves as the gateway, or the connection to, the telephone network. Without that connection, a person's ability to participate in society is limited.

In defining basic service, we are not saying that all basic service throughout the state should be subsidized. Instead, we are defining a level of service which all local exchange carriers must provide in California if they want to avail themselves of the subsidies. The definition of basic service should be thought of in terms of what is a minimum level of service that consumers have come to expect, or what services are essential to all residential telephone customers. A provider can always offer more than what the basic service definition provides.

2. Positions of the Parties

Pacific and GTEC propose a similar definition of basic service. Pacific advocates a definition developed by the United States Telephone Association which includes: voice grade access to the public switched telephone network; the ability to place and receive calls; touch tone dialing; single party service; directory listing; access to operator services; access to directory assistance; and access to emergency services. GTEC's definition would add equal access to interexchange carriers and access to telephone relay services to Pacific's list.

Although GTEC does not include local usage in its definition of basic service as part of its strategy for the FCC universal service proceeding, GTEC states that the issue of usage

is an issue the Commission may want to adopt for California. GTEC, however, points out that to implement a support program for usage will require addressing the problem of how to compare different areas within the state which have different calling scopes. Pacific questions whether local usage should be included as part of basic service, and states that rates for usage should cover costs.

DCA, DRA, UCAN and the Coalition propose similar definitions of basic service, but include certain California specific items such as the ULTS rate, access to customer service, access to information and 800 services, and information service blocking.

Public Advocates, on behalf of its clients, state that the importance of bringing universal service and full and equal access to information services to poor, minority, and non-English speaking communities cannot be understated. Public Advocates believes that there should be a goal of incorporating advanced technologies into the definition of basic service. Public Advocates says enhanced services should be incorporated into basic services when those services become available to 51% of customers in the service area. Public Advocates also contends that basic service must include guaranteed capacity to handle data transfer.

The California Alarm Association suggests that the basic service definition include the ability of the network to send simple data.

3. Discussion

DRA, UCAN and the Coalition's definitions of basic service generally reflect the level of basic service Californians currently enjoy. Pacific and GTEC's definitions tend to ignore some of the consumer protections Californians have come to expect, such as information service blocking. The large LECs advocate a minimal nationwide definition which in many respects represents a retreat from established Commission policy.

We propose that basic service should include the following elements (see proposed Rule 4, App. A):

- o Access to single party local exchange service;
- o Access to interexchange carriers;
- o Ability to place and receive calls;
- o Touch tone dialing;
- o Free access to emergency services, 911/E911;
- o Lifeline rate for eligible customers;
- o Customer choice of flat or measured rate service;
- o Access to directory assistance;
- o Access to a directory listing;
- o Access to operator services;
- o Voice grade connection to public switched telephone network;
- o Access to information services and 800 services;
- o One-time free blocking for information services and one-time billing adjustment for charges incurred inadvertently, mistakenly, or that were unauthorized;
- o Access to telephone relay service as provided for in PU Code § 2881;
- o Access to public policy pay telephones;
- o Free access to customer service for information about ULTS, service activation, service termination, service repair, and bill inquiries.

We believe that the proposed definition of what the basic service package must include at a minimum is a reasonable definition of what are essential telecommunications services. The basic service package also reflects what telephone customers have come to expect.

We also believe that the definition of basic service minimums should be the same for all local exchange providers. If different definitions were adopted for different providers, certain groups of customers might not have access to certain essential basic services. Different levels of basic service based on demographic factors could adversely impact economic growth and consumer welfare. A uniform definition allows customers who move from one part of the state to another, to obtain the same type of telephone service regardless of location. Having the same definition of basic service is also technology neutral, and promotes fair competition because a provider cannot provide reduced levels of basic service. In addition, a uniform definition prevents customers from having to purchase services that they do not need. Having a single statewide definition also makes universal service less burdensome to administer.

The Greenlining Institute, which has participated in the local competition OIR/OII, suggested at the June 9, 1995 full panel hearing on local competition that consideration should be given to free telephone service. At some point in the future, carriers may try to bundle basic service with other services and products, so that the basic service is free or set at a very low rate. For the time being, we believe that the idea of free service is best left to the marketplace to decide.

C. Review of the Basic Service Definition

1. Introduction

One of the objectives of the current proceeding is to create a mechanism to evaluate which services are essential and therefore should be part of basic service. This objective anticipates that as technology advances new services may become essential. This proceeding will adopt a process for initiating review and criteria for evaluating whether a service should be included in basic service.

2. Positions of the Parties

The parties have widely varying views on how reevaluation of the definition of basic service should occur. Pacific supports formal periodic review every three to five years. Pacific believes that a service should be included in basic service when it becomes essential and accepted. Pacific proposes that a service be considered essential when not having the service would create a significant impairment to participation in mainstream society. Pacific also states that market penetration of the service should be in the 80% to 90% range. In addition to the participation aspect and the penetration criteria described above, Pacific advocates a benefit/cost test before the service is incorporated into the basic service definition.

GTEC proposes a minimum and maximum period between reviews of universal service. Once a review has been completed a new review should not commence for two years. After this two-year period has passed, parties can petition for a review of the definition of basic service. If no petition for review has been received within five years, then a new review is initiated.

GTEC advocates market acceptance and public interest criteria. GTEC argues that the Commission would have to determine that a new feature had been widely accepted and that the market would not, without intervention, meet all of the Commission's universal service expectations.

DRA believes that the definition of basic service should not be revisited until the year 2000. DRA recommends three criteria for examining whether the service should be included in the basic service definition: (1) that the service element is necessary for full participation in society; (2) to promote more widespread subscription to the service; and (3) to prevent stratification between the information rich and information poor. DRA further suggests that penetration rates may be necessary to evaluate whether new services should be included in the basic service definition.

The Coalition argues against periodic review of the definition of basic service in favor of a review triggered by penetration rates. The Coalition suggests that widespread subscription, for example over 65% of residential customers, or a decline in penetration among low income, non-white or non-English speaking customers, should trigger formal review of the definition of basic service. The Coalition argues that high subscription alone should not result in the broadening of basic service. Instead, the Coalition suggests that the Commission determine whether the service is essential and whether the benefits of inclusion in the definition of basic service outweigh the costs. The Coalition argues that a service should be considered essential when it is necessary to enable a person to participate fully in society or to promote more widespread subscription to local service. The benefit/cost test should include a consideration of whether the inclusion of the service will raise basic rates to such an extent that penetration will decline as a result.

UCAN suggests that review of the definition of basic service be triggered when 51% of local customers subscribe to a service or if penetration levels in low income, non-white or non-English speaking communities decline significantly over a two-month period.

Public Advocates contends that enhanced telecommunications services should become part of basic service when the service is available to 51% of customers.

3. Discussion

The parties identify two issues that the Commission needs to resolve in reevaluating basic services, the establishment of a review procedure, and the criteria for evaluating when a service should be included in the definition of basic service.

The review procedure can either be a periodic formal review, or the procedure can be triggered by a measure such as penetration rates monitored by the Commission. A drawback to the periodic formal review option is that it may initiate a proceeding when there is no need to because no service meets the criteria for inclusion in the basic service package. A negative aspect of the trigger approach is that it would require an ongoing, extensive monitoring role on the part of the Commission of new and emerging technologies.

We propose adopting a periodic, formal review of the definition of the basic service package. Such a review would determine if services should be added or deleted from the package. The effective date of the Commission's initial adoption of the definition of basic service in this proceeding will start the calculation of the periodic review date. Interested parties may file a petition for modification to reopen this proceeding to reevaluate the definition at the end of three years.¹² If no party requests such a review at the end of that period, then the next opportunity for review will take place three years hence. If a review is requested and this proceeding is reopened, then the next opportunity for review will come at the end of three years

¹² The petition for modification shall be filed on or before the 180th day before the periodic review date.

from the effective date of the adoption of the revised definition of basic service. (See proposed Rule 4.C., App. A.)

Relevant and precise criteria are necessary for an efficient reevaluation of the basic service package. We propose that the Commission consider including a service in the definition of basic service if a substantial majority of residential subscribers use the service, and access to the service is found to be essential for participation in society. For the purpose of determining whether a service should be included as part of basic service, a minimum of 65% of residential customers must subscribe to the service. The 65% figure indicates that it has gained wide acceptance among consumers. In addition, the quantitative and qualitative benefits of adding the service to the basic service definition must outweigh the costs. The Commission should also consider as criteria whether intervention is necessary or if continued subscriber growth and availability would occur in the absence of regulatory action. (See proposed Rule 4.C., App. A.)

**D. Promoting Access to and the Deployment
of Advanced Technology**

1. Introduction

The universal service OII/OIR recognized that one of the goals of universal service is to provide incentives to promote the deployment of advanced telecommunication technology to all customer segments.

2. Positions of the Parties

Some parties assert that it is necessary for the Commission to take an active role in expanding the use of enhanced services among historically underserved low income, non-white and non-English speaking Californians. UCAN and Public Advocates believe that the market will not diffuse advanced technologies to underserved communities. They argue that as long as the definition of universal service depends on penetration rates, underserved communities will lag behind in receiving the benefits of advanced

telecommunications services. To address this problem, UCAN advocates a market building grant program, and Public Advocates suggests measures to prevent utility redlining of customer classes.

UCAN contends that in the absence of intervention, competing carriers will offer enhanced services to niche markets whose customers can afford them, rather than offer the services to a broad spectrum of consumers. Instead of reducing the overall subsidy, UCAN believes that a larger subsidy will result because niche markets will develop while applications that appeal to a broad spectrum of the public will fail, which will keep subsidies high.

UCAN suggests as a possible solution to this problem that the Commission create a mechanism that will work to reduce subsidies and promote broad-based, affordable, and useful applications. This could be achieved by the assessment of a universal applications incentive fee, which would be distributed under Commission guidelines through partnership arrangements. UCAN envisions grants distributed to state/local/business partnerships, which will in turn develop applications designed to meet the needs of a broad range of customers. This could then lead to the offering of this service on a broader basis, which would then reduce the amount of the subsidy required to maintain universal service.

In their comments in our local competition proceeding, the Universal Service Alliance (USA) advocates a market building strategy similar to that proposed by UCAN. USA fears that without intervention the market will serve high end customers. USA advocates a foundation which might fund community technology centers that would facilitate product development relationships between vendors and those consumers or institutions at risk of being bypassed by market forces. This foundation would be funded by telecommunications providers.

Public Advocates warns that low income, non-white and non-English speaking Californians may become victims of redlining, i.e., the refusal of advanced telecommunications providers to serve certain neighborhoods unless the Commission intervenes. Public Advocates suggests that each carrier be held responsible to build facilities and offer programming to underserved communities without discrimination on the basis of income, race, ethnicity, or geography. Public Advocates also contends that the idea of a second tier of universally available services, as proposed in the Infrastructure Report, will exacerbate this problem rather than reduce it.

The Telecommunications Education Trust (TET) believes that in the future there is going to be a distinct class of customers who have access to the digital, broadband, interactive network. TET supports the idea that the people who cannot afford the hardware to connect or the money to give them access should be given access through schools, libraries, and clinics, or through some sort of public kiosks or pay phone approach.

3. Discussion

The proposals of UCAN and USA may serve to provide greater access to new technologies by bringing providers and underserved consumers together, to develop new services, products, and applications. However, it is unclear if introduction of these services to underserved consumers will stimulate sufficient interest in and demand for these new services, products and applications, thus resulting in lower costs.

The narrow source of funding that UCAN proposes raises some concern. The type of applications UCAN speaks of involve not only telecommunications, but also software, hardware and perhaps certain types of multi-media production. Consequently, if such a program were to be implemented, then it might be appropriate for all participating companies and their product end-users to contribute, not only telecommunications providers and their

customers. However, this type of broad funding base is currently beyond the Commission's jurisdiction.

Instead of proposing a rule at this time regarding a grant program for advanced technology, we invite further comment on the grant proposals. Comments should cover the following:

- o What recommended amount of funding is necessary for such a grant program?
- o What effect will the proposal have in increasing access to advanced services?
- o Have similar types of market building grant programs been effective?
- o Should development of new and emerging products and services be left to market forces?
- o Is the general fund a more appropriate funding source for this type of program?
- o Should non-regulated entities or persons contribute to this market building fund?
- o What additional Commission and/or other resources would be needed to effectively administer such a program?
- o Who should receive the grants in order to maximize access to advanced telecommunications technology?
- o How should we evaluate whether such a grant program has been successful?

Redlining in telecommunications could be viewed as the practice of denying access to generally available advanced telecommunications services or adversely varying the terms of such access because of the conditions, characteristics or trends in particular communities. We are concerned that this possibility may lead to the development of information poor communities.

One way to solve this potential problem is to require each LEC and CLC to offer all services to anyone within their

defined service area. Carriers, however, might then try to narrowly define their service areas.

The problem that redlining raises is that a determination must be drawn between the economics of certain services, and when the deployment does not occur because of discrimination.

We invite comment by the parties on the following:

- o Will an explicit prohibition against redlining be effective?
- o What economic or market factors should be considered to determine whether lack of service availability is due to redlining or some other cause?
- o If redlining is detected, what should be the consequences?

Regarding the two-tiered approach to basic service, that proposal was contained in our Infrastructure Report at p. 19. The Infrastructure Report stated that a two-tiered approach would be designed to manage the transition toward a redefinition of basic service. The first tier would consist of conventional voice telephone service. In the second tier, it was proposed that basic digital access be added to the basic service definition. When a majority of individuals and businesses use the second tier service as a common method of conducting daily activities, it was proposed that the Commission would consider expanding ULTS support to this service.

Based on DRA's comments, it appears that the telecommunications market is already moving toward digital access. As DRA notes, all services, including voice services, will soon be carried by digital signals. Pacific and GTEC, which serve a combined 97% of the access lines in California, have announced plans for 100% deployment of digital switching by 1997.

At the present time, the definition of basic service for purposes of this proceeding, should not be expanded to include basic digital access. This may change in the near future as

digital technology becomes more commonplace. For purposes of this universal service proceeding, unless comments on these rules convince us otherwise, the only tier of basic service is the list of elements that we listed earlier.

VI. Subsidy Mechanism Proposals

A. Introduction

The Commission is committed to guaranteeing that high quality basic telecommunications services remain available and affordable to all Californians. In the universal service OIR/OII, the Commission asked parties to comment on how the Commission could ensure reasonable rates for basic telecommunications service. The OIR/OII also asked parties to recommend a mechanism which would ensure universal service in a competitive environment.

We have given these two issues some thought. Reasonable rates are intertwined with the current universal service programs. In order to keep rates at reasonable levels, the ULTS and CHCF were developed. In addition, rates have been geographically averaged so that high cost areas are offset by lower cost areas. A balance must be achieved between the size of the subsidies, and the rate.

One way to reduce the size of the subsidies is to allow rates to move toward the cost of providing service by deaveraging rates by geographic areas. However, such a move may result in very high and unaffordable rates if a rate ceiling is not imposed.

We invite comment on whether we should consider geographic deaveraging of rates in this or other related proceedings. Specifically, we invite comment on the idea of whether rates in high cost areas should be geographically deaveraged, subject to a cap that is limited to the lower of the cost to serve or 150% of the weighted average rate in low cost areas.

Instead of focusing on how rates should be structured in a competitive environment, we turn our attention to what kind of mechanism will ensure universal service in a competitive environment.

With the introduction of telecommunications competition into all areas of California, the Commission needs to reexamine the existing ULTS and CHCF mechanisms. Based on the comments, parties generally agree that the ULTS mechanism needs only minor reform in a competitive environment. A revised ULTS program can possibly be implemented before a revised high cost fund is adopted. However, many parties suggest that the subsidy mechanism for high cost areas requires more thought and planning.

B. Is There a Need to Revise the Existing Universal Service Mechanisms?

1. Introduction

The commenting parties agree that some type of funding mechanism should remain in place for income eligible telecommunication subscribers. The commenting parties also agree that many areas of the state are high cost areas which may require a funding mechanism. However, there appears to be some disagreement as to whether basic services are subsidized.

High cost areas are not restricted solely to areas within the territories of California's 20 small and mid-size LECs, but include certain exchanges of Pacific and GTEC as well. These areas are high cost for various reasons, such as a small population, and difficult terrain. With the introduction of local exchange competition, the Commission needs to develop a funding mechanism which specifically targets high cost areas throughout California.

2. Positions of the Parties

The Coalition says that the present system for preserving universal service is inconsistent with the development of a competitive local exchange market for three reasons. First, as long as internal subsidies of the incumbent LEC are used to support

universal service, potential competitive providers, no matter how efficient, will face competitive disadvantage against services which are subsidized. Second, as long as competitors contribute to a universal service funding mechanism which also subsidizes the incumbent carriers' basic exchange service, in addition to universal service goals, potential competitors may be forced to fund their dominant competitor. Third, the current system of internal subsidies can't be maintained over the long run because competition will drive the prices for services from which contributions currently may be derived closer to the actual cost of providing those services.

The Coalition proposes that before a new universal service plan is implemented, the LECs first demonstrate the need for subsidized basic exchange services through appropriate total service long run incremental cost (TSLRIC) studies.¹³ Second, the LECs must demonstrate that, if the need for a basic service subsidy does exist, the level of competition for basic service must pose a significant threat to the LEC's ability to fund the identified subsidy requirements. If after such a demonstration it is determined that a significant need for a basic exchange subsidy does exist, the Coalition believes that a competitively neutral universal service funding mechanism is required for the development of effective local exchange competition.

GTEC contends that to ensure that universal service is maintained in a competitive environment, a policy and program needs to be put in place. The cornerstone of a smooth transition to full

¹³ The Coalition defines TSLRIC as follows: "TSLRIC means the forward-looking (economic) incremental cost to the LEC caused by providing the entire quantity of the service, network building block/component or group of network building blocks/components in question, using the most efficient technology deployed most efficiently. The long run means a period long enough so that the cost estimates are based on the assumption that all inputs are variable." (Coalition's Comments, p. 3, fn. 4.)

local exchange competition is the comprehensive redesign of existing universal service funding mechanisms to ensure competitive neutrality. GTEC says that this can be accomplished by moving universal service contributions from other incumbent LEC services priced above reported costs to a mechanism that is explicit in nature. The redesign of the existing universal service internal support mechanisms ensures that the benefits of local exchange competition can be realized without jeopardizing the goal of affordable and ubiquitously available service. GTEC asserts that the continuation of current universal service policies will interfere with the development of effective local competition. Under the current system, GTEC asserts the LECs face asymmetric obligations to serve, pricing constraints, and regulatory burdens.

MCI states that the Coalition's plan permits the development of effective local exchange competition, and promotes the economic efficiencies that local exchange competition can bring. MCI contends that the Coalition's mechanism is neutral, and does not compensate the LECs for alleged competitive losses or lost revenue contribution. In a competitive environment, MCI states that the LECs may lose customers and revenue as a result of local exchange competition.

Citizens agrees that the universal service funding mechanism must be competitively neutral, and points out that a competitively neutral mechanism is one that creates the least possible market distortions.

The Cellular Carriers Association of California (CCAC) states that whatever method is chosen to subsidize universal service, it is critical that any funding mechanism must be competitively neutral among service providers, and that all providers should bear an equitable share of any such obligation.

MFS Communications Corporation (MFS) states that any system of universal service should be: (1) quantified and efficiently targeted to help those deserving of assistance;

(2) funded by a mechanism that removes funding from the LEC rate structure; and (3) neutrally administered by a disinterested party, such as an accounting, financial services, or information management firm.

McCaw Cellular Communications, Inc. (McCaw) states that the Commission should establish a goal of eliminating intercarrier subsidy programs. This can be accomplished by providing subsidy payments directly to customers, and not to carriers, and by removing subsidy rate elements in interconnection charges paid to incumbent LECs. McCaw believes that once these incentives to report higher costs are eliminated, and competition is introduced, the incumbent LECs will be forced to achieve lower costs. As a result, rates should decrease. To reach this point, McCaw states that the Commission must: (1) design a collection mechanism for customer subsidies; (2) create a competitively neutral and efficient scheme for distributing subsidies; and (3) calculate the amount of the required subsidy.

During the June 9, 1995 full panel hearing in the Local Competition proceeding, Pacific urged that local competition be delayed until a complete set of universal service rules are put into place. In Pacific's comments to this proceeding, Pacific recommends that the Commission adopt an interim universal service rate element for Pacific's interconnection service. This would remain in place until a permanent universal service funding mechanism is implemented. Pacific argues that local exchange competitors will enter the market and take away the high call volume business and residential customers. Due to the potential loss of those customers, the revenues available for internal service cross subsidies will shrink and the remaining customers and the LECs will have to bear the additional costs of serving unprofitable customers.

Public Advocates states that in order to fund universal service, there must be an identified funding source in order to

maintain the long-term viability of the program. Also, all providers of telecommunications services must contribute to the fund.

Public Advocates contends that central to the issue of a subsidy is ensuring that there are adequate cost studies to accurately determine the cost of providing universal service. Any incentives for efficiency must not impose a barrier on a company's effort to ensure that special populations are provided with affordable and accessible telephone service.

The Small LECs contend that the best method of ensuring the reasonableness of rates for basic telecommunications services, and for ensuring the availability and affordability of universal service, is to retain the CHCF. Since the small LECs have to make rate case filings by the end of 1995, they feel it would be imprudent to make changes to the CHCF program at this time.

The Smaller Independent LECs believe that there is little practical experience as to how competition will impact low density, high cost exchanges. The Smaller Independent LECs state that for the areas in which they are located, markets are extremely limited and cannot support multiple carriers. Because of these unknown effects, the Smaller Independent LECs point out that an increasing number of other states have exempted small LECs from competition until more data is available. Since the smaller LECs serve less than one percent of the access lines in California, they recommend that the Commission follow the lead of the other states and defer the introduction of competition for local exchange services in low density rural areas until such time as the Commission has had an opportunity to review the impact and effect of competition in high density, low cost sections of the state.

AirTouch says that the Commission is not authorized to implement rules for universal service under AB 3643. Instead, AB 3643 says that the Commission is to institute and complete an

investigation on universal service and report its findings to the Legislature.

3. Discussion

We agree with the parties which state that there is a need to quantify the basic service subsidy, that the subsidy needs to be explicit and separate from the LECs' existing rate structure, and that the mechanism must be competitively neutral. It is apparent that changes will be needed to the existing universal service programs funded by the ULTS and CHCF mechanisms because competition will allow competing providers to enter all markets in California. Instead of a single provider, the customer may have the choice of multiple providers. The funding mechanisms need to be redesigned to allow new market entrants access to universal service funds if they provide basic service to low income customers or to high cost areas. In addition, the mechanisms need to be changed to reflect the downward pressures on costs that competition should bring. Over time, competition and technological advancements should reduce the total amount of basic service subsidies. The revisions to the high cost fund should also reflect the change from a company subsidy to a subsidy that benefits residential customers who live in high cost areas or who are eligible for the ULTS program.

Although we do not agree with Pacific's position that local exchange competition should be postponed before final universal service rules are in place, or that an interim funding mechanism should be established, we acknowledge that competition will take some time. Potential competitors will have to establish their local exchange networks, or enter into agreements with the LECs for access to the local exchange network, both of which are complex issues to resolve. In addition, no studies have been completed that confirm that the LECs' residential basic exchange services are being subsidized by other LEC services. By the time competitors are able to make market inroads, and cost studies are

completed, redesigned universal service rules will have been adopted.

In the universal service OIR/OII, the Commission asked parties to comment on whether a new mechanism should cover both low income customers and high cost areas. The Commission asked parties specifically to comment on the voucher and auction approach, or other universal service funding methods. Based on the comments we have received, we believe that our proposed universal service mechanisms will be easier to administer and implement if the program supporting low income customers and the program for high cost areas remain separate. Once the universal service support systems are in place, and the Commission has identified the actual cost of providing basic exchange service by geographic areas, we may consider combining the funding mechanisms for low income customers and high cost areas. We will discuss the funding mechanisms for high cost areas, and for low income customers, separately in the sections that follow.

As for the comments of the Small LECs and Smaller Independent LECs that the Commission should refrain from introducing local competition and preserve the existing CHCF in their service territories, we conclude that PU Code § 709.5 controls. PU Code § 709.5(a) provides in part that "It is the intent of the Legislature that all telecommunications markets subject to commission jurisdiction be opened to competition no later than January 1, 1997." (Emphasis added.) Unless PU Code § 709.5 is amended to exempt the smaller LECs from local exchange competition, it is our belief that our redesign of universal service must apply statewide.

Another reason why the small and medium size LECs should not be treated differently than Pacific and GTEC is because most of the small LECs are dependent on the CHCF to fund their Commission authorized rates of return. However, if Pacific and GTEC become eligible to draw from a high cost fund, the funding needs for the